

Please note that the comments expressed herein are solely my personal views

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
United States
www.federalreserve.gov

Chris Barnard

23 July 2011

- Docket No. OP-1421
- **Proposed Guidance on Stress Testing for Banking Organizations With More Than \$10 Billion in Total Consolidated Assets**

Dear Jennifer Johnson.

Thank you for giving us the opportunity to comment on your proposed joint guidance: Proposed Guidance on Stress Testing for Banking Organizations With More Than \$10 Billion in Total Consolidated Assets.

The OCC, Board, and the FDIC request comment on proposed guidance on stress testing. The proposed joint guidance outlines high-level principles for stress testing practices, applicable to all Federal Reserve-supervised, FDIC-supervised, and OCC-supervised banking organizations with more than \$10 billion in total consolidated assets. The proposed guidance highlights the importance of stress testing as an ongoing risk management practice that supports a banking organization's forward-looking assessment of its risks.

Naturally stress testing should allow for shocks and variations along the following lines:

- 1) changing individual assumptions and parameters (sensitivity testing);
- 2) changing several assumptions and parameters at the same time, where the assumptions and parameters could reasonably be expected to change together (scenario testing);
- 3) changing the dependencies assumed between assumptions and parameters.

The importance of point 3 above is often underestimated. I would recommend that you specifically emphasise the importance of considering dependencies and correlations under stress testing, particularly as typically observed and expected dependencies may not apply in the tail conditions and events that underlie many stress conditions and scenarios.

Please note that the comments expressed herein are solely my personal views

I would also recommend that you should specifically refer to operational risk as a potential risk factor for stress testing.¹ Operational risk is critical as operational risk failures effectively allow other types of risk, such as credit risk and market risk to be excessive. I note that operational risk was mentioned as a risk factor for stress testing in the Basel Committee on Banking Supervision's report on Principles for sound stress testing practices and supervision.²

You mention in the commentary under Principle 4 that: "The analysis and the process should be well documented so that stress testing processes can be replicated if need be". This is a minimum requirement. However, for clarity and completeness I would recommend that you should state that actual results, as well as processes should be replicable.³

Yours sincerely

Chris Barnard

¹ Operational risk is commonly defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

² See page 3 in Principles for sound stress testing practices and supervision, BCBS, May 2009, available at: <http://www.bis.org/publ/bcbs155.pdf>

³ Results as well as processes should be robust and auditable.